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SUBJECT: CZECH REPUBLIC'S AMBITIOUS STRUCTURAL REFORM AGENDA

REF: A. 07 PRAGUE 973
¶B. 07 PRAGUE 1222

¶1. (SBU) SUMMARY AND COMMENT: Czech Finance Minister Miroslav Kalousek, during a January 24 meeting with the Ambassador, previewed the next set of planned economic reforms. Following the 2007 passage of the public finance reform bill, the government announced its intention to submit a pension reform plan by the end of last year and a healthcare reform plan in 2008. The former has been delayed and Kalousek now hopes both bills will be presented in 2008, in addition to a package of reform legislation aimed at "rationalizing and simplifying" the tax system. Given the evenly-split Czech Parliament, any controversial bill -- economic or otherwise -- is an uphill battle. Despite this challenging and short-sighted political environment, the fact that Kalousek is determined to pursue these difficult reforms is good news for the economy. Reform opponents may not change their minds, but if the current global financial turmoil and the talk of economic slowdown becomes reality, Kalousek may have more cover to pursue these tough reform goals. END SUMMARY AND COMMENT.

BUDGET NOT SUSTAINABLE WITHOUT PENSION AND HEALTHCARE FIX

¶2. (SBU) More individual participation and contribution is the key underlying principle behind both pension and healthcare reform initiatives. However, this is highly unpopular and politicians are loathe to even utter these words. As Kalousek points out, however, without these reforms, the Czech Republic cannot even contemplate the long-term sustainability of the state budget. The planned pension reform would gradually convert the current pay-as-you-go system to a fully-funded system, raise the mandatory retirement age, and offer both opt-out and supplemental plans for individuals. The proposed healthcare reforms include offering different types of insurance coverage for individuals and building on the controversial fee-for-service concept introduced by the 2007 public finance reform bill (as of January 1, Czechs pay CZK 30 - or less than $2 - per doctor visit).

¶3. (SBU) In fall 2007, Parliament passed the public finance reform bill, which some believe is as much a political as an economic achievement, given that its main element, a flat tax, was one of the Civic Democratic Party's leading campaign promises. As reported in ref A, the bill mostly addressed the revenue side of the budget equation with both corporate and income tax cuts. However, excessive social expenditures are the primary reason for the persistent fiscal deficit that is preventing the Czech Republic from adopting the Euro. Kalousek attributed the better-than-expected 2007 budget deficit results (1.9%/GDP) solely to better-than-projected GDP growth, saying "this had nothing to do with the government reforms."

RATIONALIZING AND SIMPLIFYING THE TAX SYSTEM

¶4. (SBU) In addition to the much anticipated pension and healthcare reforms, Kalousek told the Ambassador about another planned reform package that has not yet been made public. By mid- to late-February, Kalousek intends to unveil three bills aimed at the personal income tax system, the tax process, and financial and customs institutions. Kalousek is in consultation with the Prime Minister and other economic Ministers on this "legislative, administrative, and institutional" tax reform initiative that is intended to "rationalize and stabilize" the tax system. The underlying principle of the bill is to change the point at which income is taxed such that money that is adding value to the economic system (e.g. in holding companies) would not be taxed whereas money changing hands (e.g. into consumer's hands) would be taxed. Kalousek is not in a rush to push this package through but believes it is important to the transparency and stability of the tax system. He said that he would welcome views of American investors and companies once the reform package is made public.

EURO ADOPTION DATE REMAINS ELUSIVE

¶5. (SBU) Kalousek admitted that it was a "mistake" that the Czech Republic does not have a specific date for Euro adoption. However, he believes it would be worse to set a date and then slip on the timeline due to missed fiscal targets. Therefore, he informed the Ambassador that he would not/not announce a date for Euro adoption until structural reforms are approved by Parliament. Currently, the Czech Republic has identified the 2012-2013 timeframe as the earliest possible date for Euro adoption (ref B).
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